BACKGROUND ANALYSIS OF CORPORATE MINIMUM TAX ISSUES

Staff Working Paper
July 1985

The Congress of the United States
Congressional Budget Office

J932-30

This study was requested by Senator Ted Stevens. It was prepared by Valerie Amerkhail of the Tax Analysis Division under the supervision of Rosemary D. Marcuss and Eric J. Toder. Many people provided helpful suggestions and comments during various stages of the project. The author would especially like to thank Jere Brannon, Bruce Davie, Al Davis, Patrick Oglesby, Daniel Shaviro, Lin Smith, and Emil Sunley. The paper was typed by Linda Brockman and Shirley Hornbuckle. Questions regarding this analysis may be addressed to Valerie Amerkhail at 226-2680.

The current income tax system provides incentives to change economic behavior, and reduces effective tax rates on economic income, by allowing deductions and exclusions from the regular tax base that understate taxable income relative to economic income, and by allowing credits against regular tax liability. While most business incentives are available to noncorporate business (where they reduce the individual income taxes of the owners of noncorporate businesses), their impact on the tax system and on federal revenue is most noticeable with respect to corporate taxes.

The popularity of corporate tax incentives has contributed to a decline in the corporate tax share of unified budget revenues from about 21 percent in 1964 to less than 9 percent in 1984, and a decline in the effective income tax rate on corporate economic income from about 36 percent in 1964 to about 20 percent in 1984. Another result of the widespread use of tax incentives is the well-publicized ability of some major corporations to report profits and pay dividends to stockholders, while paying very low rates of federal income tax, or even receiving refunds against taxes paid in previous years. In this setting, a corporate minimum tax is being seriously discussed as a possible means both to increase corporate tax revenues and to reduce some of the variation in the burden of corporate taxes across companies, while minimizing the impact of reducing any of the incentives now in the code.

Section One of this paper analyzes some of the issues and technical details involved in the design and implementation of a corporate minimum tax. Section Two is a history of federal corporate and individual minimum taxes from the original proposals and their enactment in 1969 through the changes made in the Deficit Reduction Act of 1984. The appendix includes data on the revenues raised by minimum taxes in effect between 1969 and 1982, and revenue estimates for examples of three different kinds of corporate minimum taxes. This paper does not describe or analyze any of the specific minimum tax proposals that have been introduced during the current session of Congress. A description of some current proposals was included in a recent Congressional Research Service report[1]. A future report of the Joint Committee on Taxation will discuss current minimum tax proposals.

SECTION ONE

All the problems of balancing the use of incentives against the need for revenue, and against the desire for equal treatment of taxpayers, that characterize every effort to reform the tax code are concentrated in the design of a minimum tax. The background analysis provided in this paper is primarily concerned with minimum taxes that are intended to raise revenue (either to provide a net increase in federal revenues or to enable other taxes to be reduced). It also assumes that the tax is intended to increase the neutrality of the tax system without completely eliminating any of the

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1/ "Corporate Minimum Tax Proposals in the 99th Congress" by David L. Brumbaugh, Congressional Research Service, May 23, 1985. 15p.

incentives to which it is applied. The current additional tax on corporate tax preferences is narrowly based and does not move the tax system very far toward either goal.

The Purpose of a Minimum Tax

When a minimum tax is proposed as a means of increasing the neutrality of the tax system, the explicit intention may be either to put a floor under the effective tax rate of all taxpayers (with income above a given amount), or to limit the extent to which income can be shielded from taxation by the use of specific preferences. Unless the minimum tax base is broad enough to approximate economic income, these two purposes are, to some extent, mutually exclusive. If a minimum tax is designed to ensure that all taxpayers pay some minimum rate of tax on a particular base, taxpayers with substantial preference income may avoid the minimum tax by also having substantial nonpreference income subject to the regular tax (or by merging with someone who does.) If the tax is designed to limit the benefits from specified preferences, it may fall heavily on some corporations that already pay relatively high taxes, while leaving others untouched because their preferences happen not to be targeted by the minimum tax.

The goal of setting a floor under all taxpayers' effective tax rates is most directly served by an alternative minimum tax.[2] Limiting the benefits from specific tax preferences without directly scaling them back generally calls for an additional tax on tax preferences. The stated purpose of a minimum tax has tended to alternate between these two goals, with each revision or proposed change described as a much better way to achieve the currently favored goal than the tax it succeeds, which, in its turn, was described as the best way to achieve the other goal. As a result, the individual minimum tax has shifted from the alternative tax originally proposed, to the additional tax enacted in 1969, to one of each between 1978 and 1982, and to only an alternative minimum tax under current law. The corporate minimum tax has remained an additional tax on preferences since its 1969 enactment, but many of the major proposals to change it, including most of the current proposals, have called for an alternative minimum tax.

An Alternative Minimum Tax

The base for an alternative minimum tax is constructed by adding specified items to the regular tax base and (generally) subtracting a fixed dollar amount as an exclusion. Tax liability is calculated by multiplying the alternative minimum tax base by the alternative minimum tax rate, and comparing the resulting minimum tax liability with liability under the regular tax. The tax actually paid is equal to either the

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2/ However, an additional tax with a deduction for the regular tax liability is very similar to an alternative tax with the same preferences included in the base.

regular tax or the alternative minimum tax, whichever is larger[3], and the minimum tax rate becomes the lowest possible rate on whatever base it is applied to. Deductions and exclusions from the regular tax base are included in the minimum tax base only if they are specifically added back. If enough items were included, the alternative minimum tax base would approximate economic income (minus the exclusion), and the effective rate on economic income would be at least as high as the minimum rate.

Because an alternative minimum tax would be paid only by taxpayers with effective regular tax rates below the minimum tax rate, it would affect only a small proportion of corporations, as long as its rate was well below the average effective corporate tax rate and its exclusion was significant. For instance, the 15 percent alternative minimum tax described in the appendix, with a base that roughly approximates economic income and with a $50,000 exclusion, would be paid by about 1.9 percent of total regular domestic corporations the first year.

Under static assumptions a change in the rate of an alternative minimum tax results in a more than proportional change in the revenue raised by the tax. As the rate is increased or decreased it changes the number of corporations with effective regular tax rates below the minimum tax rate, so the gross revenue raised by the tax changes in response to both the rate and the number of corporations affected. The net revenue raised by an alternative minimum tax is the gross revenue minus regular tax liabilities that will not be paid by corporations subject to the alternative tax. As the rate rises, additional revenues from corporations already subject to the minimum tax will be net tax increases, but an increasing proportion of gross revenue from corporations newly subject to the tax will be offset by forgone regular taxes. As a result, the elasticity of net alternative minimum tax revenues in response to rate changes will decline as the rate increases, but will always be above one under static assumptions (so that the increase in revenues will be more than proportional to the rate increase). The alternative minimum tax described in the appendix, which would be expected to raise $3.3 billion in the first year at a 15 percent rate, would raise $1.6 billion the first year at a 10 percent rate, or $5.2 billion if increased to 20 percent.[4]

The Need for Carryover Provisions Under an Alternative Minimum Tax. The timing of the availability of tax preferences is determined by the timing of the activities that generate those preferences, and the timing

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3/ An alternative minimum tax could be designed, and was once proposed, under which the taxpayer would pay the smaller amount.

4/ These estimates, and the revenue estimates provided in the appendix, are based on the static assumption that economic behavior would not change in response to tax changes. Revenue estimates incorporating behavioral responses might be smaller or larger than static estimates, depending on what assumptions were made about the economic impacts of tax incentives, and how completely the behavioral responses were incorporated. (See the appendix for a discussion of possible behavioral assumptions.)

of otherwise taxable income that can be sheltered from regular taxes. Once preferences have become available, however, their use is governed by strict rules that generally do not allow the taxpayer much leeway. This lack of flexibility in the timing of the use of tax preferences does not matter to corporations with enough preferences to be subject to an alternative minimum tax for the foreseeable future. For others, however, the impact of an alternative minimum tax on the value of incentives could be very erratic and arbitrary if there were no provision to allow some future benefit from incentives that had to be claimed in a year when they could provide no current benefit because of the alternative minimum tax.

One way to deal with this problem is to allow the excess of the minimum tax over the regular tax to be carried over as a credit or deduction against future regular tax liability. Another, more complicated, way is to allow credits or deductions that do not actually provide any current tax benefit to be carried over as though they had not been used. Either provision provides some future benefit from any credits or deductions lost because of the minimum tax, provided the taxpayer eventually shifts to the regular tax. Because such carryovers would not reduce the impact of the tax on a taxpayer with enough preferences to be permanently subject to the alternative minimum tax, neither provision would undermine the tax rate floor concept.

Without such carryover provisions, imposition of an alternative minimum tax on corporations would greatly increase both the reasons for and the complexity of tax-motivated business planning. Even with such provisions, the use of preferences that are related to previous years' activities, or that for other reasons may be generated independently of profits, may cause an alternative minimum tax to fall more heavily on a corporation with relatively volatile profits than on a similar corporation with a more steady profit pattern. The corporation with steady profits may never come under the alternative minimum tax, while the one with volatile profits, and with no greater use of preferences over time, may find that, because its preferences are less volatile than its profits (or because they follow a different pattern), they trigger the alternative minimum tax in low profit years. In such a case, the impact of an alternative minimum tax would not be as neutral across corporations as a direct reduction in preferences.

The Impact of an Alternative Minimum Tax on the Present Value of Tax Incentives. Compared with a case in which there were no tax incentives and all economic income was taxed at the statutory rate, an alternative minimum tax with a lower rate than the statutory rate would still leave many tax incentives untouched. Once the alternative minimum tax had been triggered, however, the value of any incentives that reduced the effective regular tax rate below the minimum tax rate would be zero unless the minimum tax included some kind of carryover provisions. With carryover provisions, the present value of such excess incentives would depend on the timing of the minimum tax. It would be very low if the firm had so many future preferences that it could expect to remain under the alternative minimum tax indefinitely, but could be close to the nominal value if the firm expected to return to the regular tax quickly.

The Impact of an Alternative Minimum Tax on the Marginal Tax Rate. Because the minimum tax is an indirect means of scaling back the benefits from incentives, its impact on marginal tax rates can differ from the impact of a direct reduction in the incentives. The major difference between the effect of a minimum tax applied to incentives and a direct scaling back of those incentives is that the impact of the minimum tax on the preferences of any particular taxpayer depends on that taxpayer's mixture of preferences and nonpreference income. Because the alternative tax reduces the value of a preference only if the corporation's preference income is large relative to its total income, only the marginal tax rates of companies with large amounts of preference income relative to their regular income should be affected by a minimum tax.

For those companies, however, the impact of the minimum tax on the marginal tax rate can, in some cases, be considerably greater than the impact of a direct reduction in the incentives. For instance, the restriction on the use of credits against the minimum tax is equivalent to a major reduction in the proportion of regular tax that can be offset by credits. Under present law the general business credit (the sum of the ITC, targeted jobs credit, alcohol fuel credit, and employee stock ownership credit) can be used to offset 100 percent of regular tax liability up to $25,000, and 85 percent thereafter. For a company subject to the 46 percent statutory rate (with no use of incentives other than credits), but with more credits than it can use, the marginal tax rate on additional income is thus 6.9 percent (.069=.46*(1-.85)). Imposing a 15 percent alternative minimum tax on this company, thus raising its marginal tax rate to 15 percent, would have the same effect as reducing the portion of regular tax liability against which credits can be taken to 67.4 percent. (.15=.46*(1-.674))

An alternative minimum tax could reduce the value of incentives provided in the form of deductions even more than the value of credits. Because there is no current law restriction on the share of taxable income that can be offset by deductions, incentives provided in the form of deductions can reduce a company's marginal tax rate to zero, or even make it temporarily negative (by providing the basis for refunds of previous years' liabilities). In this case the increase in the marginal tax rate caused by the minimum tax may be larger than the minimum tax rate itself.

An Additional Minimum Tax on Tax Preferences

The base for an additional minimum tax is the value of specified preferences, net (generally) of a deduction for the regular income tax liability[5] and/or some standard exclusion. The base for the current

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5/ An additional minimum tax that did not allow a deduction for regular tax liability would not really be a minimum tax, because liability under it would bear no relationship to liability under the regular tax. An additional tax without either a regular tax deduction or a standard

additional minimum tax on corporate tax preferences is the sum of a relatively short list of specific corporate preferences, reduced by the greater of either $10,000 or the corporation's regular tax liability.

An additional minimum tax is paid in addition to the regular tax, so it increases the total tax liability and the effective tax rate of any taxpayer with amounts of the targeted preferences large enough to be subject to the additional tax, regardless of the size and rate of regular tax liability. If the minimum tax base includes only some of the preferences available under the regular tax, minimum tax liability may not be closely related to a taxpayer's effective regular tax rate. (Although as long as the regular tax is a deduction from the minimum tax base, the relative increase is greater for those with relatively more preference income.) This means that, to a limited extent, the additional minimum tax falls more heavily on those taxpayers that are most able to take advantage of the current system. However, unlike the case of the alternative minimum tax, some of those taxpayers may have substantial regular tax liabilities.

Because an additional minimum tax on preferences is paid by any taxpayer with substantial amounts of the targeted preferences, regardless of the taxpayer's other income and regular tax liability, it cannot generally be avoided by mergers and acquisitions, or by careful timing of investments. For this reason, an additional tax is much less likely to affect the timing of business decisions or to promote mergers and acquisitions than an alternative minimum tax.

Under static assumptions, the revenue gain from an additional minimum tax on any specified base is roughly proportional to its rate, because the number of corporations affected is determined by the definition of the base, not the level of the rate, and because the gross revenue from an additional minimum tax is not offset by any reduction in regular tax liabilities.

An Additional Minimum Tax on Broad-Based After-Tax Income

Instead of a specific list of tax preferences, the base for an additional minimum tax could be a comprehensive measure of income, net of regular taxes paid and some standard exclusion. The base for this kind of minimum tax would be defined by specifying deductions, so it would generally be much broader than a base constructed by specifying preferences, both because some preferences might be easier to include by default than by direction, and because income already in the regular income tax base would be included unless explicitly exempted. Such a tax would be equivalent to a surtax on broad-based after-tax income. Because of the broad base, it could raise a significant amount of revenue with a very low rate, and with

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exclusion would have exactly the same impact as the TEFRA-style scale-back of preferences discussed below.

less distortion in tax burdens than a surtax on regular tax liability.[6] However, such a tax would be paid by all corporations with economic income in excess of the exclusion, including corporations with no tax preferences. For this reason, the exclusion for such a tax would generally be set considerably higher than for a more narrowly based tax.

Treatment of Net Operating Losses (NOLs) Under Minimum Taxes

Incentives provided in the form of deductions and exclusions from the regular tax base reduce taxes by lowering taxable income relative to economic income, sometimes to the point where economically profitable companies are able to report losses for tax purposes, and may even be able to use NOL carrybacks to claim refunds of previously paid taxes.[7] A basic problem in the design of a minimum tax is the inability to distinguish between such paper losses and genuine economic losses. This can lead to the unintended result of either subjecting a corporation with real losses to the minimum tax, or allowing corporations with tax, but not economic losses to escape the minimum tax as well as the regular tax.

In an attempt to avoid taxing corporations with real economic losses, the present additional tax on corporate tax preferences allows a deferral of the minimum tax when a corporation reports an NOL[8]. In any year in which a corporation subject to the minimum tax sustains an NOL that can be carried forward, the lesser of the minimum tax imposed for the year or the portion of the minimum tax equal to 15 percent of the unused NOL available for carryover is deferred until the NOL can be used. This provision could be applied to a broad-based additional tax, but would not appear to be applicable to an alternative minimum tax.

Under an alternative minimum tax, one way to recognize real losses without undermining the effectiveness of the minimum tax is to set up a separate category of minimum tax NOLs which are calculated without including preferences and are allowed to reduce minimum tax liability. Either of

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6/ For instance, under static assumptions, the additional tax on aftertax economic income shown in the appendix would be expected to raise $35 billion over five years at a rate of 2.5 percent.

7/ Allowing NOLs to be carried back or forward to reduce taxes in other years has the effect of smoothing out tax liabilities over time, similarly to the way income averaging smooths individual tax liabilities over time. Most NOLs can be carried back no more than three years, so an NOL can generate a refund only if a tax was paid in at least one of the previous three years.

8/ Because of this provision, an expansion of the current minimum tax to include some of the major preferences that now allow some large, profitable corporations to report tax losses might still leave such corporations with very little current tax liability.

these solutions obviously adds to the complexity of the minimum tax, and may still treat some taxpayers more harshly than intended.

Treatment of Tax Deferrals Under Minimum Taxes

Many of the most widely used current tax incentives are tax deferrals, rather than outright reductions. Accelerated depreciation, one of the most important, causes a deferral of tax liability by allowing a greater percentage of the cost of a capital good to be deducted from taxable income during the early years of its life than is actually used up. As a result, during later years of the asset's life, depreciation deductions will be less than actual depreciation, and taxable income generated by the asset will exceed economic income. The value of the tax deferral comes from the interest which can be earned (or avoided) by the taxpayer between the time the tax would have been due and the time it is actually paid.

A minimum tax applied to the current tax benefit provided by a deferral (for instance, by including the difference between accelerated and straight-line depreciation in the minimum tax base), would reduce the benefit of the deferral more than it reduced the benefit of a non-deferral preference. In some cases, the amount of the minimum tax could be greater than the benefit from the deferral. This result would be especially likely if the current use of the accelerated deduction generated an NOL that would not actually reduce regular taxes until some time in the future when there were otherwise taxable profits against which it could be taken.

The minimum tax treatment of deferral and non-deferral preferences could be made more equal, and the likelihood that the minimum tax would completely wipe out the benefit from a deferral reduced, through the provision of the minimum tax credit or deduction carryover mentioned above. Another approach would be to reduce directly the regular tax on future income associated with a deferral-related preference that has been subject to a minimum tax. The future regular tax reduction might be accomplished through a basis adjustment in the case of accelerated depreciation and other deferrals associated with a measurable basis. The minimum tax associated with any particular preference, and, therefore, the appropriate adjustment, would be easier to apply in the case of an additional minimum tax than with an alternative minimum tax.

Treatment of Tax Credits Under Minimum Taxes

In general, tax credits are not allowed to reduce minimum tax liability, and the regular tax which determines whether the alternative minimum tax will apply, or is deducted from the base of an additional minimum tax, is the regular tax after credits. As a result, using tax credits increases the probability of becoming subject to an alternative minimum tax, and all income protected from the regular tax by credits is effectively included in the base for either an alternative or an additional minimum tax. Specific credits can be excluded from the minimum tax base by

being added back to regular tax liability before it is compared with alternative minimum tax liability or subtracted from the additional minimum tax base.

The restriction on the use of credits against a minimum tax is necessary if the purpose of the minimum tax is to be carried out, because without it those corporations that currently receive the most benefit from business credits, and are most likely to have excess credits, would also be likely to avoid the minimum tax. (An exception is usually made for the foreign tax credit, which is discussed below.)

Under an alternative minimum tax, any credits that reduce the effective rate of the regular tax below the minimum tax rate will be completely wasted unless there is some provision to allow credits that provide no current benefit to be carried over. As mentioned above, the provision of a minimum tax credit or deduction against future regular tax liabilities is one way to provide some future benefit for such credits. Another way is simply to allow the carryover of credits that, while (technically) claimed, do not provide any current benefit. Either of these provisions would reduce the benefit provided by tax credits (as the minimum tax is intended to do) without completely eliminating them.

Treatment of the Foreign Tax Credit and Foreign Tax Preferences

Unlike most tax credits, the foreign tax credit (FTC) is not designed primarily as an incentive to encourage a particular kind of behavior. The FTC is intended to ensure that worldwide income taxes (the sum of the domestic federal income tax and any income or income-type tax levied by a foreign country) on corporate profits from foreign activities will not exceed the rate of the domestic tax (or of the foreign tax, if it is higher than the U.S. rate). Under current law, the FTC can be used only to reduce domestic taxes that would otherwise be owed on foreign-source income, and cannot be used to offset corporate minimum tax liability (which, in any case, is imposed primarily on domestic preferences.)

Foreign-source income is part of the regular corporate income tax base, so it would generally be included in the base for an alternative minimum tax or an additional minimum tax on broad-based aftertax income. In these cases, allowing use of the FTC against any portion of the minimum tax attributable to foreign-source income would be consistent with the original purpose of the FTC.

The base for the current additional minimum tax does not generally include preferences resulting from activities in foreign countries or U.S. possessions unless they are used to reduce taxes on domestic income. However, if foreign-source capital gains are given preferential treatment by the source country the preference is included in the minimum tax base. This treatment is consistent with the avoidance of double taxation of foreign-source income, because such capital gains will not have been subjected to full taxation by the source country.

The U.S. tax incentives available for foreign activities are generally limited compared with the incentives available for the same activities if undertaken domestically. Therefore, including tax preferences attributable to foreign activities and not used to reduce domestic income in the base for an additional minimum tax would not be likely to provide a major source of minimum tax revenue.[9]

The U.S. possessions tax credit is an incentive designed to encourage economic activity in U.S. possessions. The income on which the credit is based would generally be included in the base for an alternative minimum tax. The credit could be designated as a preference subject to an expanded additional minimum tax.

The Role of a Standard Exclusion in a Minimum Tax

Most minimum taxes allow some standard exclusion from the minimum tax base. The present law additional minimum tax on corporate tax preferences is applied to specified preference income above the greater of either $10,000 or the regular tax liability. The alternative minimum tax proposal described in the appendix would exclude $50,000 from the minimum tax base, while $100,000 would be excluded from the base of the additional minimum tax on aftertax economic income also described in the appendix. These standard exclusions tend to increase the progressivity of the corporate income tax across the lower end of the corporate income distribution.

As with the lower regular tax rates on the first $100,000 of corporate income under present law, a minimum tax exclusion can be considered a concession to small corporations, comparable to, but not as appropriate as, the personal exemption under the individual income tax.[10] A more practical purpose, however, is to limit the application of the minimum tax to those taxpayers who obtain enough benefits from tax incentives to suggest that they already have the tax expertise necessary to handle the additional complexity of the minimum tax. A minimum tax exclusion also has the effect of limiting the number of taxpayers affected by the minimum tax without significantly reducing the revenue from the tax.

9/ An exception is the excess of deductions for intangible drilling costs (IDCs) over net income from oil, gas, or geothermal properties. IDCs used to reduce domestic corporate taxes on income from foreign activities could be a substantial addition to a corporate minimum tax base. (They are subject to the present additional tax on corporate preferences only when received by a personal holding company.)

10/ Such concessions to small corporations are not generally considered as appropriate as concessions to low income individuals because the size of a corporation may bear little relationship to the economic income of its shareholders.

"Grandfathering" Under Minimum Taxes

In general, any proposed minimum tax would be applied only to preferences associated with activities undertaken after the effective date of the proposal. This means that preferences generated by activities undertaken before the tax takes effect will usually not be directly included in the minimum tax base. As long as NOLs and ITC carryovers cannot be used against minimum tax liability, however, any preferences associated with pre-minimum tax investment which have not been used before the tax is implemented will be affected by the tax. An additional minimum tax on broad-based aftertax income would be applied directly to preferences associated with pre-minimum tax activities, unless such preferences were explicitly listed as deductions from the minimum tax base.

Grandfathering would greatly restrict the revenue raised by a minimum tax implemented at the same time as a broad-based tax reform that restricts the number of new preferences, unless the minimum tax were specifically structured to include old preferences. Also, if a new alternative minimum tax replaced the present additional tax on tax preferences, preferences currently subject to the minimum tax would escape further taxation unless they were specifically included in the new minimum tax base, or some provision were made to continue the old minimum tax as long as the old preferences remained.

The Impact of Minimum Taxes on Investment Behavior

The most important corporate incentives in the current tax code are those intended to stimulate business investment. Investment incentives account for such a large portion of the total revenue cost of tax incentives that if a minimum corporate tax is intended either to raise a significant amount of revenue, or to ensure that every corporation pays some minimum rate, it must include most of the major investment incentives in its base.

The Aggregate Level of Investment. If an incentive has been successful in stimulating the activity it is designed to encourage, any reduction in that incentive would be expected to have some negative impact on the targeted activity. Investment tax incentives are enacted in the belief that they will increase the level of investment in capital goods. The extent to which they have succeeded is a matter of extreme controversy that is beyond the scope of this paper. If investment incentives are assumed to have increased the aggregate level of investment beyond what would otherwise have occurred, then the reduction in the value of those incentives produced by a minimum tax would obviously cause a reduction in the increase in the investment level.

The Distribution of Investment by Type. Regardless of the impact of tax incentives on aggregate investment, there is general agreement that the existing tax system changes the mix of investment by favoring some kinds of capital goods more than others, and that the resulting investment mix is

less efficient than what the market would have determined.[11] A minimum tax on investment incentives would fall most heavily (in absolute amounts) on the preferences associated with the most favored types of capital goods. For this reason, a minimum tax might have some tendency to reduce distortions in the investment mix caused by the existing system of investment incentives. An additional minimum tax would probably be more likely to promote a more efficient investment mix than an alternative minimum tax, because it would introduce fewer new distortions.

The Timing of Investment. For an individual firm, many of the factors discussed above (especially the marginal tax effects of an alternative minimum tax) can be expected to affect the timing of investment decisions, just as the availability of the incentives targeted by the minimum tax may affect the timing of investment decisions. For instance, under present law a corporation investing a regular yearly amount in equipment eligible for 5-year accelerated depreciation under the Accelerated Cost Recovery System (ACRS) will experience the maximum benefit from the accelerated depreciation in the fifth year of its investment program. If the base of an alternative minimum tax included a preference associated with accelerated depreciation on equipment, and if this peak effect were enough to trigger the tax, that corporation might choose to delay the fifth year's investment. If a significant number of corporations began regular investment programs in the same year, many of them might face the same decision at the same time. It is conceivable that the result could be a measurable impact on the timing of aggregate investment. If aggregate investment were still expanding strongly at that time, the effect of the minimum tax could be to moderate and extend the expansion. However, if investment were already weakening, the minimum tax could exaggerate the downturn.

The Role of a Minimum Tax in Comprehensive Tax Reform

In a completely incentive-free income tax system all economic income would be taxed at the statutory rate, so there would be no need for a minimum tax. Even in a system much more broad-based than the present one, however, as long as any incentives remained there would be at least the potential for some taxpayers to escape taxation. Therefore, a minimum tax could still have a role in such a system if one of the goals of public policy was to have all economic income bear some portion of the tax burden.

There might also be a role for a minimum tax in the transition to a broad-based corporate income tax system, especially if the level of revenue raised during the transition was a concern. Tax reform proposals do not generally include changes in benefits already earned, but not yet

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11/ Investment distortions caused by the tax system were discussed in a recent CBO report, "Revising the Corporate Income Tax" May 1985.

taken.[12] For many corporations, the generous investment incentives of recent years have resulted in such large overhangs of unused ITCs and NOLs that they could still remain untaxed for an extended period even if all incentives were repealed immediately. As a result, the "level playing field" that is one of the goals of broad-based tax reform would not exist until all old credits and incentive-related NOLs had been used up. If this situation was deemed undesirable, a minimum tax that could not be offset by credits or NOLs would be one way of taxing such corporations quickly. Some might, however, regard this as a retroactive form of taxation.

Alternatives to Minimum Taxes that have Similar Characteristics

The scale-back of corporate tax preferences initiated in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and extended in the Deficit Reduction Act of 1984 (DEFRA) is similar to an additional minimum tax on those preferences. In fact, in order to avoid reducing the value of the targeted benefits by more than the direct amount of the scale-back, the current law minimum tax was revised to apply only to the portion of the preferences allowed after the scale-back (see Section two). The TEFRA/DEFRA scale-back of preferences is applied to the entire amount of the preferences, with no exclusion. Because there is no exclusion, the scale-back is generally the same proportion of the targeted preferences, regardless of the relative importance of the preferences to the taxpayer, and regardless of the mix of preferences used by the taxpayer. This approach is more simple to apply than a minimum tax. It also leaves no possibility of avoiding the reduction in value of the targeted preferences, short of forgoing them entirely.

The limit on artificial accounting losses (LAL) proposed in 1973[13] would have allowed losses defined as artificial (those resulting from accelerated deductions) to offset only related income. This restriction on the use of tax preferences to shelter unrelated income, and the resulting reduction in the value of tax deferrals, would make LAL very similar to an additional tax on those preferences provided in the form of accelerated deductions. The combination of LAL applied to accelerated deductions and a minimum tax applied to non-deferral preferences would avoid the problems associated with applying a minimum tax to deferral preferences.

12/ Even the "windfall recapture" provision in the President's Tax Reform Proposals would not apply to ACRS benefits that have not yet been used. The NOL carryovers generated by ACRS deductions that have not yet reduced taxes could be used to offset the windfall recapture tax while remaining available to reduce future regular tax liability.

13/ This proposal was intended to apply only to individuals, but could be adopted for corporations.

CONCLUSION

A minimum tax is a blunt instrument. It reduces the value of the tax incentives to which it is applied, and reduces the ability of taxpayers to completely escape income taxes or to shelter major portions of their income from taxation. At the same time, it increases the complexity of the tax system, and may, under some circumstances, hit some corporations harder than intended, or cause even more tax-motivated behavior than the incentives it is designed to reduce. However, the original tax incentives targeted by the minimum tax are also blunt instruments, which reward taxpayers whether or not they would have engaged in the desired behavior without the tax incentives. Therefore, the usefulness of minimum tax proposals should be judged in the context of the tax system in which they would be included, not in comparison to an ideal tax system.

If an increase in the total level of taxes paid by corporations should become a general goal of public policy, a broad-based minimum tax would be more neutral than a surtax or an increase in the regular tax rate. However, it would be more complex, and less neutral, than direct measures to broaden the regular corporate tax base, including some, such as a broad scale-back of preferences, that would have many of the positive attributes of a minimum tax. Should a minimum tax be enacted, either as part of a broad-based reform, or as a single best-attainable provision, an additional minimum tax would probably cause less economic distortion, and might raise revenue more efficiently, than an alternative minimum tax.

SECTION TWO: A HISTORY OF MINIMUM TAXES [14]

The minimum tax proposal included in the Treasury Department's Tax Reform Studies and Proposals, published in 1969, was for an alternative tax on individuals, with progressive rates from 7 percent to 35 percent, applied to an expanded income base that would have included the following tax preferences:

- o The excluded portion of net long-term capital gains;
- o Interest received on state and local bonds;
- o Percentage depletion in excess of capital invested; and
- o Appreciation of property deducted as a charitable contribution.

Less important exclusions from regular taxable income, and preferences involving tax deferrals rather than exclusions, were not included in the proposed minimum tax base in the interest of simplicity. The minimum tax base would have been reduced by personal exemptions and by the greater of either regular itemized deductions plus expenses associated with tax exempt interest or an alternative standard deduction of $10,000. Separate net operating loss calculations, with separate carryback and carryover accounts, would have been required for minimum tax purposes. Credits allowed against the regular tax would have been allowed against the minimum tax, but with more severe limitations on the foreign and investment credits.

The tax was designed to ensure that no more than 50 percent of an individual's economic income could be shielded from taxation through the use of tax preferences. As a result, the minimum tax would not apply unless a taxpayer's excluded income was greater than his regular taxable income, and a taxpayer subject to the minimum tax would pay about half what he would have paid at regular rates if none of his income had been excluded.

Corporations were exempted from the proposal on the grounds that the bulk of corporate tax preferences were concentrated in a small number of industries, so the distortions they caused could best be handled by changing the tax structures of those industries. Also, the progressive rate structure, which was considered essential to the basic equity goal of the tax, would be harder to justify if the tax were also applied to corporations.

Under a second proposal, taxpayers not subject to the minimum tax would have been required to allocate certain nonbusiness deductions (interest and taxes, casualty losses, charitable contributions, medical

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[14]/ This history is concerned with minimum taxes and related provisions and proposals which apply to individual taxpayers subject to the individual income tax and regular corporations subject to the corporate income tax. No attempt has been made to include special provisions applied only to personal holding companies.

expenses, and cooperative housing expenses) between taxable and nontaxable income. Exclusion of a given amount of income from the taxpayer's taxable base would have prevented a proportional share of the targeted deductions from being used to reduce the remaining taxable base.

With the change in Administration in early 1969, the Treasury's minimum tax proposal became a Limit on Tax Preferences (LTP). Under this version, if the sum of specified tax preferences exceeded 50 percent of gross income (including the preferences), the excess was included in taxable income. The list of preferences specified in this proposal did not include capital gains or tax-exempt interest, but added intangible drilling costs, accelerated depreciation on real property, and farm losses.

The bill adopted by the House in August 1969 included the following preferences:

- The excluded portion of net long-term capital gains;
- Interest received on state and local bonds;
- Accelerated depreciation on real estate in excess of straight-line over the same life;
- The exclusion of appreciation on property deducted as a charitable contribution; and
- Farm losses in excess of losses calculated under accrual accoun ting. methods

The LTP would have provided the same limit of 50 percent of income excluded from regular tax as the previously proposed minimum tax. It would also have been restricted to taxpayers whose total tax preferences exceeded $10,000 in one year.

Following passage of the House bill, the Treasury proposed to the Senate Finance Committee an LTP with the following tax preferences:

- The excluded portion of net long-term capital gains;
- Accelerated depreciation on real estate in excess of straight line over the same life;
- Farm losses in excess of losses calculated under accrual accounting methods;
- Percentage depletion in excess of capital invested;
- Intangible drilling expenses;
- Interest, taxes and rent expensed during construction; and
- Accelerated depreciation on leased personal property in excess of straight-line over the same life.

The very different minimum tax proposed by the Senate Finance Committee was an additional tax on both individuals and corporations of 5 percent of the excess of the sum of their tax preferences over $30,000. This approach was considered preferable to the House version because it did not involve the interaction between the preference limitation and the regular tax computation that the LTP would produce. It was also described as more appropriate for a tax on corporations than an alternative tax because it is harder for a corporation to escape an add-on tax through

merger. In addition to limiting the benefits from tax preferences, the goal of the Senate version was to treat taxpayers with the same amounts of preference income alike, regardless of their regular incomes. The Finance Committee's proposal became the basis for the minimum tax enacted in the Tax Reform Act of 1969.

THE TAX REFORM ACT OF 1969

The minimum tax enacted in 1969 was an additional tax of 10 percent on the excess of the sum of specified tax preferences of individuals and corporations over the sum of $30,000 and the regular income tax after credits. The specified preferences included the following:

- The excess of investment interest paid over net investment income (only until 1972, and not for corporations);
- Accelerated depreciation on personal property subject to a net lease in excess of straight-line depreciation over the same life (not for corporations);
- Accelerated depreciation on real property in excess of straight-line depreciation over the same life;
- Amortization of certified pollution control facilities or railroad rolling stock in excess of otherwise allowable depreciation;
- The excess of the fair market value of stock options at the time of exercise over the option price;
- Bad debt deductions of financial institutions in excess of what would have been allowed on the basis of actual experience;
- Percentage depletion in excess of the adjusted basis of the property; and
- Capital gains--the preference is the income excluded from the regular tax by the special treatment of capital gains. For individuals this is the portion excluded from Adjusted Gross Income. For corporations the preference is determined by multiplying net capital gains by the formula: (statutory tax rate - alternative tax rate on capital gains)/statutory tax rate.

If the use of tax preferences resulted in a net operating loss (NOL) carryover, the minimum tax on an amount of preference income equal to the carryover was deferred until the year the carryover was exercised. No credits, including the foreign tax credit, were allowed against the minimum tax. Foreign-source stock options and capital gains were included in the minimum tax base only if untaxed or taxed at preferential rates by the foreign country. Other foreign source-preferences were considered part of the minimum tax base only if they reduced U. S. taxable income.

THE EXCISE, ESTATE, AND GIFT TAX ADJUSTMENT ACT OF 1970

The minimum tax was amended in 1970 to allow deduction from the minimum tax base of the "unused regular tax carryover," which was defined as the excess of a previous year's regular tax over preference income above $30,000. The unused regular tax could be carried forward up to seven years.

THE REVENUE ACT OF 1971

In 1971, amortization over a 60-month period was allowed for depreciable property within the United States used for on-the-job training or a child care center (primarily for employees' children). The excess of this rapid amortization over the depreciation deductions otherwise allowed became a preference subject to the minimum tax.

The provision for rapid amortization of child care facilities was originally intended to apply for five years, was extended for another five by the Tax Reduction and Simplification Act of 1977, and expired after 1981. The provision for rapid amortization of on-the-job training facilities was repealed by Public Law 95-30 for expenditures made after 1976.

THE ADMINISTRATION'S TAX REFORM PROPOSALS OF 1973

In 1973 the Treasury Department proposed replacing the individual minimum tax with two new provisions: Minimum Taxable Income (MTI) and a Limitation on Artificial Accounting Losses (LAL). MTI was intended to restrict the ability of individual taxpayers to reduce their taxes using exclusions. LAL was intended to restrict the use of deferrals to reduce taxes on unrelated income by deferring accelerated deductions until the associated income was realized.

The MTI would have made every individual taxpayer's taxable income at least as large as his minimum taxable income, which was defined to equal half his "expanded adjusted gross income" (EAGI). EAGI would have been calculated by adding to adjusted gross income the excluded portion of net long-term capital gains, the excess of percentage depletion over adjusted basis, the excess of the fair market value of a qualified or restricted stock option over the option price at the time of exercise, and certain exempt income from foreign sources; and subtracting personal exemptions, a standard exemption of $10,000, investment interest to the extent of investment income, and extraordinary medical expenses or casualty losses.

The LAL would have defined an "artificial loss" as the amount by which accelerated deductions in the taxable year exceed associated net related income (associated income calculated without regard to the accelerated deductions). Accelerated deductions would be allowed only up to the amount of net related income. Artificial losses would be added to a Deferred Loss Account, which could be deducted from net related income in

succeeding years, or taken into account upon the sale or other disposition of the associated property.

THE TAX REFORM ACT OF 1976

The minimum tax was not believed to have accomplished its goal of increasing the effective tax rate on high-income individuals and corporations, who were seen as not paying their fair share of taxes. In the 1976 act, therefore, the rate was increased to 15 percent and the exemption was reduced to the greater of either $10,000 or the regular tax deduction (which was defined as the full regular tax for corporations, but one-half of the regular tax for others). The list of preferences subject to the individual minimum tax was expanded to include excess itemized deductions, intangible drilling costs, and a larger portion of accelerated depreciation on leased personal property. The deferral of the minimum tax on preferences that result in a NOL carryover was retained, but the carryover of regular taxes as a deduction from the minimum tax base was repealed.

The Minimum Tax on Corporations. The minimum tax base for corporations was the sum (reduced by the greater of $10,000 or the full regular tax liability after credits) of the following tax preferences:

- Accelerated depreciation on real property in excess of straight-line over the same life;
- Amortization of certified pollution control facilities, railroad rolling stock, on-the-job training facilities, and child care facilities in excess of otherwise allowable depreciation;
- Bad-debt deductions of financial institutions in excess of what would have been allowed on the basis of actual experience;
- Percentage depletion in excess of the adjusted basis of the property; and
- The proportion of net long-term capital gains determined by the formula: (statutory tax rate - alternative tax rate on capital gains)/statutory tax rate.

The full regular tax deduction was retained for corporations because corporate income is also subject to the individual income tax when distributed as dividends or realized as capital gains. The following special rules applied to the timber income of corporations, and had the effect of exempting timber income from the increase in the minimum tax:

- The definition of the minimum tax preference for timber capital gains (and the deduction for regular taxes) was scaled down to produce the same result as keeping the minimum tax rate at 10 percent; and

- The deduction from the minimum tax base of unused previous years' regular taxes, which was generally repealed, was maintained for taxes attributable to timber income (with the deduction limited to timber tax preferences).

The Minimum Tax on Individuals. The minimum tax base for individuals was the sum (reduced by the greater of $10,000 or one-half the regular tax liability after credits) of the following preferences:

- Accelerated depreciation on real property in excess of straight-line over the same life;

- Amortization of certified pollution control facilities, railroad rolling stock, on-the-job training facilities, and child care facilities in excess of otherwise allowable depreciation;

- The excess of the fair market value of stock options at the time of exercise over the option price;

- Bad-debt deductions of financial institutions in excess of what would have been allowed on the basis of actual experience;

- Percentage depletion in excess of the adjusted basis of the property;

- The portion of net long-term capital gains excluded from AGI;

- The excess of itemized deductions other than medical and casualty over 60 percent, but not over 100 percent, of AGI;

- Intangible drilling costs deductions in excess of either straight-line amortization over ten years or cost depletion (applied only to productive wells); and

- The excess of accelerated depreciation on personal property subject to a lease (this preference was expanded from net leases to all leases, and from the excess over straight-line on the same life to the excess over straight-line on the guideline life).

THE TAX REDUCTION AND SIMPLIFICATION ACT OF 1977

The intangible drilling costs preference subject to the add-on minimum tax on individuals was changed to include only the excess over oil and gas production income. This change was intended to limit tax shelters without discouraging increased exploration. (The change was to last for one year only unless there was further Congressional action.)

THE REVENUE ACT OF 1978

The Revenue Act of 1978 created a new alternative minimum tax on individuals that applied only to capital gains and excess itemized deductions. The add-on minimum tax on individuals was retained for all other preferences. The reason for the change was the belief that the add-on minimum tax might have discouraged capital formation. The dual goals of equity and capital formation were considered to be more attainable if individuals with substantial capital gains income were subject to a minimum tax only if their regular tax liability (including the revised add-on minimum tax) was very low.

The Alternative Minimum Tax on Individuals. The alternative minimum taxable income base was gross income reduced by allowable deductions, increased by "excess itemized deductions," and including all capital gains other than gains from the sale of the taxpayer's principal residence. Excess itemized deductions were itemized deductions other than medical, casualty, and state and local taxes, and deductible estate taxes attributable to income of a decedent, in excess of 60 percent of AGI minus those deductions.

The alternative minimum income tax rate schedule was as follows:

Alternative Minimum Taxable Income	Percent
$0 to $20,000	0
$20,000 to $60,000	10
$60,000 to $100,000	20
Over $100,000	25

If the resulting amount was larger than the regular tax (including the revised add-on minimum tax) would be, the alternative tax amount would be paid. Only the foreign tax credit and refundable credits were allowed against the alternative minimum tax, and foreign tax credits were only allowed to reduce the alternative tax attributable to foreign-source income. If investment credits, jobs credits, or WIN credits provided no tax benefit in a particular year because of the alternative minimum tax, they could be carried back or forward under the usual carryover provisions.

Changes in the Additional Minimum Tax on Individuals. The capital gains preference and excess itemized deductions, the two preferences subject to the new alternative minimum tax on individuals, were removed from the list of preferences subject to the add-on minimum tax.

The 1977 change in the intangible drilling costs preference was made permanent.

Changes in the Additional Minimum Tax on Corporations. The definition of the foreign-source capital gain preference subject to the minimum tax was changed to avoid the double taxation that would occur if the minimum tax was applied in the case of reorganizations involving corporate stock in countries that do not normally give preferential treatment to capital

gains, but which give nonrecognition treatment for reorganizations requiring recognition for U.S. tax purposes.

THE ECONOMIC RECOVERY ACT OF 1981 (ERTA)

While minimum taxes were not of direct concern in ERTA, some of the major changes in regular tax structure required corresponding changes in minimum taxes.

Change in the Alternative Minimum Tax on Individuals. ERTA reduced the maximum tax rate on capital gains under the regular individual income tax from 28 percent to 20 percent. In order to conform to this change, the top rate for the individual alternative minimum tax was reduced from 25 percent to 20 percent, leaving the top bracket of alternative minimum taxable income at $60,000 and above.

Changes in the Additional Minimum Tax on Individuals. Under the Accelerated Cost Recovery System (ACRS) enacted in ERTA, most personal property could be depreciated for tax purposes significantly faster than under prior law. The resulting increase in the tax benefits available for leased personal property was recognized by a change in the tax preference for leased personal property. This preference was changed from the difference between accelerated depreciation and straight-line over the same life to the difference between accelerated depreciation and straight-line over an extended recovery period (with the half-year convention and no salvage value).

Under ACRS the tax life for real property was reduced from its useful life (generally 35 years or more) to 15 years. (The resulting tax benefits were not as great as this reduction implies, because ACRS also ended the practice of component depreciation, under which major portions of a building were frequently depreciated over much shorter lives.) The tax benefits from this change were increased by the definition of the tax preference for accelerated depreciation on real property. For real property depreciated under ACRS, this preference was defined as the difference between the accelerated depreciation allowed by ACRS and straight-line over 15 years.

Change in the Additional Minimum Tax on Corporations. The definition of the tax preference for accelerated depreciation on real property described under changes in the additional minimum tax on individuals also applied to the additional minimum tax on corporations.

THE CORPORATE MINIMUM TAX PROPOSED IN THE ADMINISTRATION'S BUDGET FOR 1983

As part of a standby revenue proposal to be implemented only if outlay reductions and economic growth did not produce a sufficiently lower budget deficit, the Administration's 1983 budget proposed replacing the add-on corporate minimum tax with an alternative corporate minimum tax of 15 percent on broadly measured corporate profits in excess of $50,000, to

be paid if it exceeded the regular tax. The Treasury Department's explanation of the budget's revenue proposals stated that while the present corporate minimum tax applied to corporations that had reduced their regular tax liability through the use of designated tax preferences, many corporations still paid little or no federal corporate tax while reporting large profits to shareholders. The proposed minimum tax was intended to apply only to profitable corporations with low regular tax liability.

The base proposed for the alternative minimum tax was regular taxable income (excluding NOL carryovers or carrybacks) plus the following special deductions:

Items already subject to the existing additional minimum tax

- Accelerated depreciation on real property in excess of straight-line over the same life
- Amortization of certified pollution control facilities or child care facilities in excess of otherwise allowable depreciation;
- Bad debt deductions of financial institutions in excess of what would have been allowed on the basis of actual experience; and
- The excess of depletion over the adjusted basis of the property.

New tax preferences included in the alternative minimum tax on corporations

- Intangible drilling and development cost deductions (other than for dry holes) in excess of straight line amortization over 10 years;
- Deductions for mining exploration and development costs in excess of straight-line amortization over 10 years;
- Lessors' benefits from safe harbor leasing (depreciation plus interest less rent on the leased property in excess of the cash paid by the lessor to the lessee amortized over the lease term);
- Interest deductions for debt used to buy or carry tax-exempt securities;
- DISC income not taxed currently; and
- Shipping income not taxed currently because it is deposited in construction reserve funds or capital construction funds under the Merchant Marine Act;
- Amortization of motor carrier operating rights (under an ERTA provision designed to compensate owners of motor carrier operating rights reduced by deregulation);

- Excess interest on original-issue discount bonds; and

- Deductions for certain costs associated with long-term contracts that would not have been allowed if the contracts had been entered into after enactment of proposed changes in the method of accounting for long-term contracts.

NOLs, and credits other than the foreign tax credit, would not have been allowed against the minimum tax, and any NOLs or credits allowable in computing the regular tax would have been treated as used, even in years when the corporation paid the alternative tax. The foreign tax credit would have been allowed against any alternative minimum tax attributable to foreign-source income, but there would have been no carryover of excess foreign tax credits. To prevent the complete loss of benefits from NOLs, credits, and preferences which result in tax deferrals, in a year in which the alternative minimum tax was paid, the difference between it and the regular tax would have been carried over for up to 15 years as a credit against the regular tax.

Vehement protests against the proposal were based on the arguments that it would significantly reduce the ability of corporations to use their accumulated investment tax credits, that it would increase the taxes paid by banks by more than 50 percent, and that it would apply to corporations, such as Chrysler that had experienced extended unprofitable periods, as soon as they became profitable.

THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 (TEFRA)

The add-on minimum tax on individuals was repealed by TEFRA, and the base of the alternative minimum tax on individuals was expanded. The reason given was that the add-on tax had applied to some middle-income taxpayers who had substantial preference income but also paid substantial regular taxes, while the primary intent of the minimum tax had been to ensure that high-income individuals would pay some tax. The change was intended to increase tax liability only for taxpayers in income classes above $50,000. Some preferences subject to the corporate minimum tax were scaled back, and the portion of those preferences included in the minimum tax base was reduced. Other preferences were removed from the corporate minimum tax base.

Changes in the Alternative Minimum Tax on Individuals. The alternative minimum tax on individuals was changed to a flat rate of 20 percent on alternative minimum taxable income above $30,000 ($40,000 for joint returns). The adjusted itemized deductions preference was removed from the base, and several new preferences, including all preferences previously included in the base of the add-on minimum tax except the amortization of child care facilities (which had expired) and amortization of railroad rolling stock, were added to the alternative minimum tax base. In addition, several new deductions from the minimum tax base were allowed. As a result, the base for the alternative tax on individuals is now adjusted gross income (without NOL deductions, but negative if other above-

As under prior law, the foreign tax credit is allowed only against the portion of the minimum tax attributable to foreign-source income. No other credits (except refundable credits) are allowed against the minimum tax, but carrybacks and carryovers are allowed under normal rules for credits which provide no tax benefit because of the minimum tax.

When the minimum tax applies, special minimum tax net operating loss calculations account for differences between the regular tax base and the minimum tax base.

Changes in the Additional Minimum Tax on Corporations. Under TEFRA certain corporate tax preferences were cut back by 15 percent, so that only 85 percent of each of those preferences could be used to reduce regular taxable income. The add-on minimum tax for corporations was modified in conjunction with the scale-back to avoid reducing the benefits from those preferences by more than 15 percent. This was accomplished by including only 71.6 percent[15] of the value of the scaled-back preferences in the minimum tax base. The following corporate tax preferences which are subject to the corporate minimum tax were reduced by 15 percent:

- The excess of depletion on iron ore and coal over the adjusted basis of the property;
- Bad debt deductions of financial institutions in excess of what would have been allowed on the basis of actual experience;
- Capital gain on real estate sold by a corporation (the amount treated as ordinary income is increased by 15 percent of the additional amount that would be treated as ordinary income if the property were subject to full recapture); and
- Amortization of certified pollution control facilities in excess of otherwise allowable depreciation.

The preferences for amortization of child care facilities (which expired at the end of 1981) and for amortization of railroad rolling stock were removed from the corporate minimum tax base.

THE DEFICIT REDUCTION ACT OF 1984 (DEFRA)

Under DEFRA, the 15 percent cutback in specified corporate tax preferences enacted in TEFRA was expanded to 20 percent for all preferences

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15/ This was the percent required to prevent the combination of the scale-back and the additional minimum tax on corporate tax preferences from reducing the marginal benefit of the preference by more than the additional tax alone would have reduced it for a taxpayer at the 46 percent statutory tax rate, with more than $10,000 of regular tax liability, and with more tax preferences than tax liability.

except depletion on iron ore and coal. In conjunction with this cutback, the share of the specified preferences (again excluding depletion on iron ore and coal) included in the minimum tax base was reduced from 71.6 percent to 59 and 5/6 percent.

The recovery period for domestic real property under ACRS was lengthened from 15 years to 18 years for property placed in service after March 15, 1984. This change affected the tax preferences for accelerated depreciation subject to the additional minimum tax on corporations and the alternative minimum tax on individuals.

As a result of the changes made in TEFRA and DEFRA, the base for the corporate minimum tax now includes the following preferences:

- Accelerated depreciation on real property in excess of straight-line over the same life (15 years for low income property or 15 year ACRS recovery property placed in service before DEFRA, 18 years for 18 year ACRS recovery property);
- Percentage depletion in excess of the adjusted basis of the property (71.6 percent of the excess for depletion on iron ore or coal);
- 59 and 5/6 percent of the amortization of certified pollution control facilities in excess of the otherwise allowed depreciation;
- 18/46ths of net capital gains reported by corporations, plus approximately 23 percent of the additional capital gains that would have been reported on the sale of real property if it had been subject to full recapture; and
- 59 and 5/6 percent of bad-debt deductions of financial institutions in excess of what would have been allowed on the basis of actual experience.

Special provisions continue to limit the minimum tax rate on timber preferences to 10 percent.

As with prior law, for a year in which a corporation has a net operating loss that can be carried over to a later year, the lesser of either the minimum tax for that year or a portion of the minimum tax equal to 15 percent of the NOL carryover is deferred until the NOL is used.

APPENDIX

REVENUE RAISED BY ACTUAL MINIMUM TAXES [16]

Additional Minimum Tax on Corporate Tax Preferences

Revenue Raised in Millions of Dollars

Year	Total	From Corporations with $250 Million Plus Assets	
		($)	(%)
1969	3.1	0.4	13.5
1970	265.2	220.8	83.2
1971	279.1	231.2	82.9
1972	315.9	260.7	82.5
1973	335.1	275.3	82.1
1974	346.8	290.5	83.8
1975	156.7	103.5	66.0
1976	192.9	130.0	67.4
1977	227.5	167.5	73.6
1978	340.5	212.6	62.4
1979	432.6	294.2	68.0
1980	438.8	306.5	69.9
1981	524.9	390.1	74.3
1982	477.7[p]	na	na

Source: Internal Revenue Service, Statistics of Income: Corporate Income Tax Returns.

16/ Statistics of Income tabulations of the revenue raised by a minimum tax are not comparable to estimates of the revenue effects of those taxes. In the SOI, the impacts of a minimum tax on the revenue loss from credits or on the volume of deductions taken would show up as lower levels of credits and deductions claimed, and higher regular tax liabilities. SOI data on alternative minimum taxes show the total amount collected under the minimum tax, not the net revenue after subtraction of regular taxes that would have been collected in the absense of the minimum tax.

Individual Minimum Taxes

Revenue Raised in Millions of Dollars

Year	total	From Individuals with $1 Million plus AGI ($)	(%)
Individual Minimum Tax on Individual Tax Preferences			
1970	112.5	23.7	21.0
1971	111.8	17.6	15.7
1972	216.3	51.9	24.0
1973	182.3	31.1	17.1
1974	142.6	24.0	16.8
1975	144.1	30.5	21.2
1976	1000.3	108.5	10.8
1977	1322.9	142.2	10.8
1978	1514.5	124.8	8.2
1979	309.2	19.6	6.3
1980	412.6	28.2	6.8
1981	565.6	46.1	8.2
1982	450.7[r]	58.0	12.9
1983	8.1[p]	na	na
Alternative Minimum Tax on Individuals			
1979	865.9	82.9	9.6
1980	850.3	80.5	9.5
1981	1261.3	162.7	12.9
1982	1069.2[r]	195.7	18.3
1983	1930.9[p]	na	na

Source: Internal Revenue Service, Statistics of Income: Individual Income Tax Returns.

REVENUE ESTIMATES FOR EXAMPLES OF MINIMUM TAX PROPOSALS

The following revenue estimates were provided to CBO by the Congressional Joint Committee on Taxation (JCT), early in 1985. The JCT's revenue estimating methodology is currently being revised, and the estimates for these minimum tax examples can be expected to change once the revisions are completed. These examples are intended to illustrate the size and pattern of static revenue effects that might be associated with broad-based minimum taxes of the three types discussed in Section one.

The static assumptions under which the following revenue estimates were made include the assumption that the level and timing of the preferences targeted by the minimum tax would not change. This assumption implies, in turn, the assumption that the economic activities the preferences were originally intended to promote would not be changed by the imposition of the minimum tax. Static assumptions are the customary basis for revenue estimates, both because there is no general agreement about the magnitude of first order behavioral responses to tax incentives, and because the ultimate revenue effect of any tax change depends upon interaction of the first order behavioral response with the entire economy, including any response of monetary policy, about which there would be even less general agreement.

Possible Impacts of Behavioral Assumptions on Revenue Estimates. If tax incentives are assumed to increase the total level of the activities they promote, it would be reasonable to expect a minimum tax targeted on particular incentives to have some impact on the level of the activities promoted by those incentives. The effect of that impact on the minimum tax revenue estimate would depend on both the size of the impact on the targeted activities, and the revenue-raising efficiency of the promoted activities in the context of the entire economy. For instance, if investment incentives are assumed to increase the aggregate level of investment, a minimum tax targeted on investment incentives would be expected to reduce investment. This reduction would tend to decrease accelerated depreciation deductions, thus increasing the short-run revenue gain from the minimum tax. If additional tax-motivated investments are assumed to increase the total level of economic (and tax-paying) activity, the investment reduction would eventually reduce total revenues, so the revenue effect of the minimum tax might eventually be smaller than the static estimates. On the other hand, if investment incentives were assumed to change only the mix of investment, and if tax-motivated investments were assumed to be less efficient than market-determined investments, then anything, including a minimum tax, that reduced the tax motivated distortions might be expected to raise revenues by more than static estimates would show. This result would be especially likely if revenues from the minimum tax provided enough fiscal restraint to prompt an easing of monetary policy.

An alternative minimum tax would be very likely to cause an increase in tax-motivated mergers and acquisitions. Such a behavioral response would directly reduce minimum tax revenues, probably by increasing amounts as the minimum tax rate increased.

Additional Minimum Tax on After-Tax Economic Income

Addition to CBO Baseline	Annual Added Revenues in Billions of Dollars					Cumulative Five-year Addition
	1986	1987	1988	1989	1990	
5 % rate	8.5	13.1	15.0	17.0	19.3	72.9
2.5 %rate	4.3	6.2	7.2	8.2	9.3	35.2

Base equals broadly defined "economic income" reduced by both the regular corporate tax liability and an exclusion of $100,000. Economic income is defined as business receipts minus allowable business expenses such as wages and salaries, cost of materials, payments to qualified pension plans, and straight line depreciation of business assets over useful lives (approximated by ADR midpoint lives for equipment and 40 years for structures.) As a result, the base would include income already taxed under the regular corporate income tax, and most items currently defined as tax expenditures.

With the exception of the foreign tax credit, credits and NOLs are not allowed to reduce minimum tax liability.

The present additional tax on specified corporate tax preferences is assumed to be repealed.

The effective date is assumed to be January 1, 1986.

Expand The Existing Corporate Minimum Tax to Include Most Items Currently Defined as Tax Expenditures

Addition to CBO Baseline	Annual Added Revenues in Billions of dollars					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
15 % rate	2.2	4.3	5.7	7.6	11.5	31.3

Base includes the following corporate tax preferences:

- Accelerated depreciation in excess of straight line over ADR midpoint lives for equipment, and 40 years for structures;[1]
- Percentage depletion in excess of the adjusted basis of the property;[2] [3]
- Amortization of certified pollution control facilities in excess of otherwise allowable depreciation;[2] [3]
- 18/46^{ths} of net capital gains reported by corporations;[2] [4]
- Bad debt deductions of financial institutions in excess of what would have been allowed on the basis of actual experience;[2] [3]
- Excludable foreign sales corporation (FSC) income;
- Intangible drilling expenses in excess of cost depletion;
- Interest deductions for debt used by financial institutions to buy or carry tax-exempt securities; and
- Contributions to capital construction funds allowed under the Merchant Marine Act.

The effective data is assumed to be January 1, 1986.

(for preferences not currently subject to the minimum tax, only preference income associated with activities initiated after 1/1/86 would be included in the minimum tax base)

1/ Under present law a small portion of this; the accelerated depreciation on real property in excess of straight line over the allowable tax life, is included in the additional tax on tax preferences.

2/ Subject to the present additional minimum tax on corporate tax preferences.

3/ Includes only the portion still usable after the scale-back of corporate tax preferences provided by TEFRA and DEFRA.

4/ For capital gains reported on the sale or disposition of real property the minimum tax applies only to the portion of the preference still usable after the scale-back of corporate preferences provided by TEFRA and DEFRA.

Alternative Minimum Tax on Broad-Based Corporate Income

Addition to CBO baseline	Annual Added Revenues in Billions of Dollars					Cumulative Five-Year Addition
	1986	1987	1988	1989	1990	
15 % rate	3.3	5.5	6.1	6.6	9.7	31.2

Base includes current taxable income minus a $50,000 exemption and plus the following corporate tax preferences:

- Accelerated depreciation in excess of straight-line over ADR midpoint lives for equipment, and 40 years for structures;[1]
- Percentage depletion in excess of the adjusted basis of the property;[2] [3]
- Amortization of certified pollution control facilities in excess of otherwise allowable depreciation;[2] [3]
- 18/46^{ths} of net capital gains reported by corporations;[2] [4]
- Bad debt deductions of financial institutions in excess of what would have been allowed on the basis of actual experience;[2] [3]
- Excludable foreign sales corporation (FSC) income;
- Intangible drilling expenses in excess of cost depletion;
- Interest deductions for debt used by financial institutions to buy or carry tax exempt securities; and
- Contributions to capital construction funds allowed under the Merchant Marine Act.

The current additional minimum tax on corporate tax preferences is assumed to be repealed.

No credits other than the foreign tax credit and the U.S. possessions tax credit are allowed.

No NOL deductions are allowed.

The difference between the alternative tax and the regular tax would be carried over up to 15 years as a credit against the regular tax.

The effective date is assumed to be January 1, 1986.

1/ Under present law a small portion of this,- the accelerated depreciation on real property in excess of straight line over the allowable tax life, is included in the additional tax on tax preferences.

2/ Subject to the present additional minimum tax on corporate tax preferences.

3/ Includes only the portion still usable after the scale-back of corporate tax preferences provided by TEFRA and DEFRA.

4/ For capital gains reported on the sale or disposition of real property the minimum tax applies only to the portion of the preference still usable after the scale-back of corporate preferences provided by TEFRA and DEFRA.

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